

MEETING OF THE BOARD OF BANK ADVISORS

May 29, 2013

9:00 am

Department of Financial Institutions
324 South State Street, Suite 201
Salt Lake City Utah

Minutes

BOARD MEMBERS PRESENT:

Dave Brown, and Eric Schmutz.

DEPARTMENT OF FINANCIAL INSTITUTIONS STAFF PRESENT:

Commissioner Ed Leary, Tom Bay, Paul Allred, Eva Rees, and Sonja Long.

OTHERS PRESENT:

Roger Shumway, Bank of Utah; Ray Dardano, Marlin Business Bank; Leonel Castillo, American Bank of Commerce; J. Ryan Nielsen, American Bank of Commerce; Michael Fosmark, Continental Bank; John Sorenson, Home Savings Bank.

1. Call Meeting to Order – Chairman Eric Schmutz

2. Minutes –

No quorum, so minutes will be discussed at the next meeting.

3. CSBS/FRBSL Questions – Tom Bay

Tom explained that this is normally the Board of Bank Advisors meeting, but the department decided to use this meeting to solicit some feedback from the industry on the community banking industry. We are doing this on behalf of CSBS and the Federal Reserve. Tom read a letter from CSBS and the FED. They will use this information at a Community Banking Research Conference this fall. A copy of the questions were sent out prior to this meeting. Responses will be rather informal; no names will be associated with the responses.

1. Describe the single greatest opportunity and the single most significant challenge your community bank has experienced in the markets in which you currently operate:

Opportunities:

- It changes; we once again have an opportunity to consider expansion or loans again. To make a difference in the communities where we serve.
- For the first time in five years, felt optimistic about this year in getting back to the business of banking, which is lending in the community. He sees lending as a huge challenge right now; there are so many companies that are in the lending business. The interest margins are being squeezed so tightly that it makes you wonder how long you can sustain an operation and meet all of the requirements that we have before us. One of the things that he wrote down was to get out of consumer lending business. That would be a tragedy if we get out of the “consumer” business. And yet his bank has tripled their compliance expense. Going forward there are some opportunities to change their business models.
- Sometimes we have a bit of trouble getting to different customers. Customers only have opportunities at different times of their maturation of their companies. Right now when they go out to seek financing it is good for them, but bad for us because they can find multiple people who are seeking the same dollars. It is good for us that we can get in their door and show them who we are and what we can offer. It is bad for us because of net interest margins and changes in structure.
- We are looking at diversity. Everyone is awash in liquidity and with rates the way they are everyone has a mindset that they want the lowest rate possible FOREVER. We are seeing margins that are so low.

Challenges:

- Mortgage impact on customers.
- Net interest margins; lots of different types of lenders chasing the same dollar.
- Some of large regional banks are making it impossible to price competitively. They are reaching down below market more and more.
- We are having to take more credit risk to keep some margin.
- We offer products that are customized and moving forward the community banks have lost the ability to offer a customized product. I.e., as of January 2014 community banks will be out of the 1 – 4 family market. It is because we cannot offer a balloon on those products to protect us from market risk. And we cannot do a loan greater than 43% debt ratio. In the past we have had portfolios that come to us and we can look at it and determine the risk and make the loan if we want. That has been taken away from us.
- The community banks have lost their competitive edge. And because of CRE issues we are not able to expand into those areas which give a higher yield.
- Leasing, longer than 12 month may become a balance sheet item.
- New competition, i.e. paypal that are not regulated.
- Large institutions that are taking our customers away from us. And they have a competitive advantage over community banks.
- Traditional definitions have changed.
- The delivery system in deposit taking is changing.

The FDIC issued a study on community banks last December. Their conclusion was that rural community banks are here to stay because there is no choice in terms of borrowing. As you talk about the payment system, it is hard to compete because Google just came out with a payment system that is free.

Tom had a couple of questions: How do you see actual physical brick and mortar branches in the future? Is that an opportunity? Is there a way to leverage those branches?

Bank B has a branch in Tropic; it was the heart and soul of that community. It is very important to that community. In some of the other areas of the state, they may not be the case.

In the Salt Lake area, Bank C is not seeing the activity in their branches, but more on the mobile devices. Bank D is looking to downsize their branches in the Salt Lake area because they are not utilizing their space. No one at the table is looking at adding branches.

The 25 – 35 aged professionals will not even enter your branches. They do everything on their phones.

Non-interest income is one of the challenges today. We need to look at all types of diversification. That is different for community banks.

Commissioner Leary asked, for a lending platform, is there anything better than a branch? Do you have a mechanism for lending outside of the branch? People are an issue as well. Getting people to come into banking is difficult. It would depend on consumer vs commercial. Someone said that it is hard to compete with credit unions on the lending side. It doesn't always take a branch to lend. Some people said that it only takes a phone for a lot of their customers. He thinks that people want the least amount of disruption.

2. Describe the single greatest opportunity and the single most significant challenge, at a national level, that could impact the community bank business model.

See the opportunities and challenges above. The deposit problems and technology issues are truly at a national level. We need to wake up and recognize that the core is obsolete.

Banker A doesn't sleep at night because he feels that the CFPB has a total lack of accountability. There are changes that have been delayed in the CALL Report but the banks will be asked to gather consumer preference information for the CFPB. It appears that the FFIEC has five members and the CFPB has one member and everyone rolls over for them. Their purpose is worthwhile, but the checks and balances that are lacking makes him nervous.

Commissioner Leary said that it makes him nervous as well. He feels that the other agencies don't quite know how to deal with them yet. It has been a rocky and difficult start. Some of the way that the CFPB wants to go, he doesn't see the other agencies

backing them on that. It is a political decision at the end of the day. They do have in their law that they have to work with the States, so they have been working with us.

The challenge that Bank B feels frustrated that they don't have any specific voice individually, but the opportunity through the State is our voice. They just aren't large enough to have that voice individually.

Commissioner Leary said that he knows that most State Banking Commissioners feel that community banks are their heart and soul.

There is a large disconnect with the CFPB. They have jurisdiction over the large banks, but they say that they want the community banks to survive and yet the rules that they are putting in place makes it more difficult.

3. How important are “scale”, or size, and scope, or product diversification, to the viability of the community bank business model?

It is hard to look at the money involved in technology and compliance requirements. You may also see consolidation in community banks. Everyone agreed that there is consolidation in the future of community banking.

Non-community bankers how do you see the community banking model going forward? One of them said that most of their business is done over the phone. Everything in community banking starts at the board level. He thinks that there is a huge need for community banking in this country. He feels that community banks need to be involved in their community.

The other non-community banker said that there is not a day that goes by for his bank that they do not talk about opportunity and anytime that there is a lot of change going on, there is tremendous opportunity. We can either talk about what we have lost or we can try to figure out how to take advantage of whatever that change is. It is important as a banking community that we lead. One of those ways that we can lead is with some level of optimism. We need to figure out that we are where we are, but there is tremendous opportunity out there. We really need to think outside the box.

Tom said that he thinks that what he heard is that those of you that have boards that are closely tied to the community could have an advantage.

4. What characteristics of bank management and bank boards of directors are important to high performance of a community bank? Is the group comfortable talking about the number of members on their boards?

- Very traditional board, as high as 13 board members, currently down to 10. Last month was the first board meeting that they went paperless. Diversity is becoming more important to them as well.

- 6 on the board, non-community bank, national focus, very appropriate for their business. The most important characteristic is the blend.
- 9 board members, it is okay. He feels that they need to understand accounting and look out for the good of the bank, not their individual needs. They need to be conservative and analytical. Listen to what is being presented and be able to ask the questions that show they understood and can see the next level. Be able to challenge management that they are the best that they can be.
- 8 people on the board, it is good because there is a lot of open dialog, there is some regular disagreement that can be worked through. The willingness of board members to speak up makes everyone look at all sides. The characteristic that has served his board well is that there has been a real discipline that we are a conservative institution. We wanted to make sure that we weren't rolling against long odds to make something work. If they have a challenge as a board it is that they are on the older side as a board. They recognize that banking has become a very technical thing. They also have great foresight in our bank.
- 5 board members, their independence is the important characteristic for this board. They are also people that challenge the bank with their suggestion as well.
- 5 people on the board. The unique thing is that they are an owner/operator bank. They have told the board that they have to be independent. They have to be able to tell the bank no. The challenge that they have is that board needs to feel comfortable expressing their opinion regardless if it is in agreement.

Question to everyone, what would make someone want to be a board member today? It is extremely challenging for the exposure that they have. Tom asked what the solution to that is. We are in a risk business; community banks have higher risks because of the added regulatory risk. Those who understand that risk are the ones that you want on the board.

5. Describe the financial services model that you believe can best survive in regions that are experiencing declining population growth and economic decline, and what role financial services providers can play in stabilizing or restarting growth in such regions. Are there any supervisory or regulatory impediments to institutions in those roles?

We have all experienced economic decline. One of the big challenges, one of the things that lead to the problems that we had was the mark-to-market on real estate. When you have a natural disaster somewhere, the FDIC comes out with guidelines on how to help people and the institution that is affected by the disaster. As a regulatory body, there could be more assistance, particularly in terms of time provided, to solve problems when there is an economic downturn.

Post recession there are people who can't get access to reasonable credit. It really puts a damper on the ability of a community to rebound with limited access to credit and limited ways for banks to extend credit because of the restrictions that the regulators have put on them.

One banker described the stated income loans that his bank used to make and today those are classified as sub-standard loans, but they always performed. They can't make those types of loans today. The change of the regulatory environment is that those individuals that are small business people are now locked out of the borrowing market. He thinks that is another issue that needs to be addressed. Customization of community banks has been greatly reduced. The pendulum has swung too far in the opposite direction. Maybe there needs to be another classification of loans. The regulators could help us with the rules for community banks with some flexibility.

Commissioner Leary asked if we need a bifurcated regulatory system. The issue becomes what is the break point and the people managing that break point. Would the community bank systems be better off with that type of system? There was a lot of discussion about that with regulators. Maybe it needs to be a different charter with a different set of rules. One comment was that there should be a tax advantage. They think that things could be a lot clearer. The regulators don't interpret things the same way. Some commonality in the way that things are administered would help.

4. Other business

Commissioner Leary thanked everyone for coming and for participating in this process. He was with the Federal and State regulators last week one of the sessions they talked about these town hall meetings and that 15 or so had already done theirs. Some of the points that he took from those were:

- Concern over competition, large banks and credit unions, and farm credit.
- Mortgage rules and capital rules.
- Good bankers are hard to find!
- Bifurcated system.
- Compliance regs put them out of business.
- Washington DC doesn't understand community banking to this day!

From the FEDS perspective:

- Compliance heavy going forward
- Can't customize loans under new regs
- Some kind of third party review needs to be conducted before the rules become effective; viable, cost prohibitive, etc.
- Standards of products
- No one is the ideal size
- Successful management needs diversity of experience and opinion
- Industry needs contemporary thinkers
- Regulators need to have more sensitivity with fair lending
- Can community bank models survive if the bank is not in the payment system going forward

- Rural America and community banking is not the focus of the national elections right now
- Regs across the board are not built for small communities or small community lenders

When this is finished, will this boil down to a summary? Yes, it will boil down to some type of report in the fall and it will be distributed back to the states. Most of the states planned to participate.

Tom thanked everyone for their participation. He also gave out his quarterly update handout.

5. Date of next meeting – August 26, 2013 – 9:00 am